

THE STAN KELLY MEMORIAL LECTURE 1983
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**FINANCIAL MARKETS —
LIBERTY OR LICENSE?**

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ECONOMIC SOCIETY OF AUSTRALIA
VICTORIAN BRANCH

FOREWORD

The Stan Kelly Memorial Lecture has been generously endowed to the memory of William Stanley Kelly, OBE, by his son Charles Robert (Bert) Kelly. The Victorian branch of the Economic Society of Australia is delighted to have been entrusted with the responsibility of organising the lecture series.

Stan Kelly, a South Australian farmer, was a member of the Commonwealth Tariff Board in Melbourne from 1929 to 1940, during which time he developed a close connection with the Victorian Branch of the Economic Society. He was also prominent as Chairman of the South Australian Advisory Board of Agriculture 1922-24, as a representative of the Australian Wool Board on the Wool Secretariat in London 1940-41, as advisor on primary products to the Commonwealth Prices Commissioner 1942-48, as Chairman of the Joint Dairying Industry Advisory Committee 1951-53, and as a member of the Consultative Committee on Import Policy 1952-60.

Stan Kelly was a proponent of free international trade, a view shared by his modest Member/Farmer son, Bert. Their preferences are preserved in the theme of the Lecture series: "The desirability of maintaining free the channels of trade throughout the world".

This year's Stan Kelly Memorial Lecturer is Mr R.A. Johnston, Governor of the Reserve Bank of Australia. Mr Johnston was born in Melbourne and received his formal education at Essendon High School and the University of Melbourne. He worked with the Commonwealth Bank of Australia from 1940 to 1960, except for a period with the RAAF from 1943 to 1946. In 1960 he continued work with the Reserve Bank of Australia when it was formed as a separate entity from the Commonwealth Bank. He has served in a number of positions, notably Deputy Manager and Manager Investment Department 1964-70, Chief Manager International Department 1970-76, and Chief Representative in London 1976-77. From 1977 to 1979 he served as Executive Director of the World Bank Group in Washington, returning to the Reserve Bank as Secretary from 1980 to 1982. In 1982 he was appointed Governor of the Reserve Bank.

The Victorian Branch of the Economic Society is delighted that one of Mr Johnston's early formal lectures in his new position of Governor should be the 1983 Stan Kelly Memorial Lecture.

Robin Stewardson
President

INTRODUCTION

It is a particular honour and pleasure for me to be invited to deliver the 1983 Stan Kelly Memorial Lecture.

First I must pay tribute to Stan Kelly himself and, of course, to his worthy son for their unremitting efforts in the cause of tariff reform. The struggle to bring enlightenment has been hard. I was struck by a remark of Keynes recalled in the Sydney Morning Herald today. "It is irrational," said Keynes, "to act rationally in an irrational world". At the very least, though, it is something to know that by the persistence and persuasion of the Kellys many of us have come to be able to at last recognise irrationality in protectionism even if we do little about it.

I cannot say that I first learnt about protectionism from this now-famous family. Rather it was reading from Shann in my days at Melbourne University. I took his book off the shelf today and was struck once again by his lucidity. His chapter "How Tariff Protection Grows" begins, "In the politics of a protectionist country there is no ease". 50 years on, nothing has changed!

I cannot say either that I had had the pleasure of meeting Bert Kelly until today, though like most of you, I have been a reader of his articles for many years. His name will endure.

FINANCIAL MARKETS — LIBERTY OR LICENSE

The title of this address owes a good deal to the spirit of Stan Kelly. Whilst I have nothing to say tonight about free trade and protection in physical commodities, my theme, namely regulation or non-regulation in the financial sector, in a sense parallels protection and free trade.

At the outset I must make two explanations. First when I look at the title of this address I realise that I have been guilty of fostering an ambiguity. By licence, did I mean "licentiousness" or "authority or permission"? Let me clear that up by saying I meant to enquire whether society was better served by freedom of markets or by regulation of markets.

I have a precedent for this confusion. Milton said "licence, they mean when they cry liberty". Clearly he had licentiousness in mind. Of course Milton was a bureaucrat and it was not therefore unnatural for him to believe that deregulation would lead to disaster. It is said that the world is divided into optimists and pessimists. Optimists get unpleasant surprises. Pessimists get pleasant surprises. Bureaucrats perhaps pretend to be pessimists since often, they hope for the best while preparing against the worst. Bertrand Russell wrote that "too little liberty brings stagnation and too much brings chaos". This begs questions of how much is too much and how much is too little. But it is not, for all that, an untrue description of the thought processes of many bureaucrats.

The second explanation I have to make is that my canvas tonight will be much more limited than I had planned when first this talk was mooted. I had in mind to analyse several facets of existing regulation within the financial system.

To test whether regulation or deregulation would serve the community better in, for example, the allocation and cost of finance; and in regard to entry into some restricted areas of financial activity. However, the Government has since set up a small group — The Martin Group — to look into what the Campbell Committee had to say in these areas. Whilst the Bank will have some views to put before that Group, I don't want to pre-empt the Group by speaking about them tonight.

Instead, I will confine my remarks to one very basic issue, namely, *confidence in the financial system* and how this might best be achieved.

As we all know, an efficient financial system is a prerequisite for the most effective operation of the economy. The most worked-over application of this is in regard to the allocation of resources. As I have said, I have ruled myself out from examining that aspect further tonight. In any event I believe that the efficiencies derived from confidence in the soundness of the market itself, contribute at least as much to welfare as does the allocative role. The cost of a major loss of public confidence in the soundness of financial markets could well outweigh the cost of allocational distortions arising from regulation.

How is this confidence best maintained? If we were to take a totally libertarian view we might begin with the proposition "caveat emptor" interpreted with some licence as "let the parties to a financial transaction take care of their own interests". I would be the last to suggest that individuals should be excused from concerning themselves with their own interests. They ought to be the best judges of their own interests.

Adam Smith in the "Wealth of Nations" wrote "to restrain private people, it may be said, from receiving in payment the promissory notes of a banker for any sum whether great or small, when they themselves are willing to receive them, or to restrain a banker from issuing such notes, when all his neighbours are willing to accept them, is a manifest violation of that natural liberty which it is the proper business of law not to infringe but to support . . .". Here is the voice of liberty!

But Smith went on to say "but those exertions of natural liberty of a few individuals, which might endanger the security of the whole society can, and ought to be, restrained by the laws of all governments, of the most free, as well as of the most despotic". Here is the voice of intervention!

In Smith's day, as now, financial activity encompassed a wide range of transactions having many levels of risk and reward. Usually the two go together — low risk and low return; high risk and, if the venture is successful, high return; and a variety of positions in between.

For the purist, I will note that the average rate of return on high risk ventures should exceed the average return on low risk ones. Smith was not objecting to this. Indeed such a spectrum was vital, then as now, for economic growth. Rather he was concerned with abuses or mis-uses of the system. One such

mis-use occurs when people put themselves in the wrong part of the spectrum.

Financial intermediaries by their nature are subject to hazards affecting their liquidity and net worth or solvency.

A prime example is the susceptibility of financial assets to rapid changes in value because of movements in interest rates.

Another is the mismatching of maturity of liabilities and assets. Of course the problems are compounded where interest rates are not flexible.

Further, financial intermediaries tend to be relatively highly geared, i.e. to have relatively high ratios of outside liabilities to shareholders' funds. Fluctuations in net values or earnings on funds employed, even though small in relation to total funds, can have a major impact on shareholders' funds.

I leave out of this catalogue the consequences of simply bad investments.

What can and should be done to moderate these problems?

First is the role of law and good standards of performance — voluntarily or compulsorily applied. These are fundamental but need not take up much of our time tonight.

Second, is the availability of timely and adequate information. Again, this is vital but need not detain us except to say that much still needs to be done in this area in Australia.

Third, it is the responsibility of the monetary authorities to see that the general level of liquidity in the economy is adequate to sustain otherwise well-managed and viable entities. I am speaking here of liquidity in the aggregate. It is up to the individual entity to ensure that it gets its share.

Fourth, ignorance of risks is no excuse — at least for the financial intermediary, although, like drunkenness, it is sometimes pleaded as an extenuating circumstance. Again, so far as liquidity is concerned, benign bureaucracy has been at pains to create assets specially suitable for the portfolios of financial intermediaries, e.g. Treasury Notes, deposits with authorised dealers in the Short Term Money Market.

Beyond these general measures, we come to the question of intervention. Is it desirable, and for whom? Clearly if we were to intervene to make all entities "safe" — to provide protection all round — we would soon destroy the risk spectrum. The provision of risk finance is socially desirable, provided lenders and borrowers know what they are about.

Also, of course, intervention implies costs — direct and indirect, including the possibility of misallocation of resources.

Further, one can be so keen to insure solvency as to keep the inefficient in business and to provoke inflation.

Nevertheless, a case can be made, given the present state of business obscurity and the existence of many small less-than-fully informed investors — that we need at least some institutions about which the community can feel completely confident.

It is of course open to society to demand more than that and to label other groups of intermediaries as having some particular characteristic that warrants protection. That is a matter for governments to determine weighing the needs of the community against the disadvantages discussed a little earlier.

The banks fall into the first group. The community can feel confident without the need to make more than superficial enquiries that they will promptly repay their liabilities in full at maturity.

In the course of their business the banks provide an essential service, namely the payments machinery — cash repositories, cheque and other forms of funds transmission, etc. — which enables other layers of intermediation to carry on their functions. Any want of confidence in the payments mechanism would have a sharp and severe impact on the operation of the whole economic system.

Banking in Australia was developed before the passage of any specific banking legislation here. Nowadays, banks' liquidity and solvency are under the supervision of the Reserve Bank. The Bank is explicitly required to use the powers given to it for the purpose to protect the depositors of the several banks established under the federal banking legislation. The particular provisions are complex in the extreme. They are loosely spoken of as a guarantee but in law they are something less than that. Apart from that requirement, the Reserve Bank of course is concerned with the solvency of the banks as part of its concern for general financial stability. This is not to say that banks are totally immune from capacity to go out of business, but they should do so without distress to their depositors.

Apart from the banks, the nine authorised dealers in the Short Term Money Market are the only entities to have direct access to Reserve Bank liquidity and to come under the prudential supervision of the Bank. These arrangements operate under a contract between the several dealers and the Reserve Bank and are in recognition of the part the dealers play in the securities markets and the leverage they provide for monetary policy.

It has been suggested that access to a similar liquidity facility would enhance public confidence in other groups of financial intermediaries. The Reserve Bank has resisted this for several reasons.

Access to such a facility might enable an institution to withstand temporary pressure on its funds but could only be helpful in the long run if the institution were solvent.

In general the Bank believes that intermediaries should seek to establish support arrangements with their own banks who should be in the best position to make judgements about the needs and ultimate viability of potential borrowers. The Bank has in fact facilitated the setting up of such arrangements. Individual banks have been asked to stand behind the liquidity needs of individual financial institutions which are responsibly managed and financially viable. These arrangements have been in place for several years and have been tested under pressure.

Widened access would carry with it the risk of monetising additional tranches of private liabilities and add to the difficulties of monetary management.

The Campbell Committee generally endorsed the Bank's approach. It did however recommend that the Commonwealth should explore with the states the feasibility of encouraging the establishment of industry-based liquidity support instrumentalities.

Because the Reserve Bank is the ultimate source of liquidity, the committee further recommended that such instrumentalities might, at the Reserve Bank's discretion, join the banks and the Money Market dealers as having special access to the Reserve Bank. Any such instrumentality should however become subject to Reserve Bank supervision. This recommendation remains a recommendation.

The Campbell Report emphasised that use of support facilities by institutions which were not viable would be prejudicial to good disciplines of financial management and should be avoided.

I should perhaps say a word here about the place of banks' subsidiaries and associated companies. In its prudential supervision, the Reserve Bank consolidates the accounts of banks and their subsidiaries and associates. As an illustration, the shareholders' funds invested by banks in these other companies are deducted from banks' capital for the purpose of calculating banks' own net capital positions. Neither as regards prudential oversight or liquidity support does the Reserve Bank accord any preferential status to banks' subsidiaries and associates.

Next to the banks along the spectrum come those intermediaries such as insurance companies, building societies and credit unions which the community and governments on their behalf regard as desirable to protect, either because they provide services of high social priority, or involve large numbers of small investors, or both.

I have already mentioned the Campbell Committee recommendations concerning the establishment of industry-based liquidity support instrumentalities.

As regards the stability of those groups of intermediaries the authorities — for the most part state authorities — often intervene to insist on high managerial standards, disclosure and dissemination of information, close supervision or regulation of borrowing and lending activities and the encouragement of association among like entities in order to spread risks, etc.

Effectively done, these can be very useful services contributing to financial stability generally.

Supervision — effective but flexible supervision — is no easy task. It requires a thorough knowledge of the industry concerned and the aspirations and affairs of the component firms. It may involve the setting up and policing of norms of conduct. This is one reason why the Reserve Bank has stuck to the supervision

of processes which it understands. A difficult balance has to be struck between engendering sound practices and investor confidence on the one hand and allowing the firm or industry reasonable scope to grow and to innovate. It is true that growth not based on sound practices will soon founder. Nevertheless at times the extent to which the supervising authority should override the exercise of commercial judgement by the enterprise itself can call for very careful thought.

One other form of protection for investors worth special mention is deposit insurance. The building society movement is in the process of setting up a scheme at present. This is a very sensible, self-help development.

Under insurance schemes, risk assessment usually passes from the individual to the insurer. The premiums paid by the insured need in total to be less than the alternative cost of regulation by the bureaucracy. Certainly insurance has the economic advantage of the user paying for the service. If the premia are related to a careful assessment of actual risks involved, insurance should be less distortive than "across the board" regulation.

The insurer may, not unreasonably, wish to exercise some control over the activities of the insured risk. It is sometimes suggested that therein lies a potential conflict with monetary policy. This prospect is lessened to the extent that monetary policy is carried out through indirect means, e.g. through market operations. Also, of course, it is lessened if the group of institutions is further down the monetary hierarchy than M2 and M3, etc.! In the Australian setting, with a few but large units (in contrast to, say, the USA) direct supervision of the banks by the Reserve Bank is simpler and probably cheaper. Moreover, the central bank is the only adequate source of funds to stop a run of any size on banking institutions.

Yet further out along the spectrum is the great body of intermediaries which facilitate the process of economic activity but which perform no especially nurtured function.

Funds placed with them tend to be more in the nature of what is normally understood by investment — in which greater elements of risk and possible loss or large reward are present. For these entities normal commercial considerations operate, including much freer entry into and exit from their chosen industries without necessarily involving the authorities. "Necessarily" is an important word here. In reality, the authorities would always be concerned to know whether the troubles of one intermediary is likely to be isolated or whether a chain-reaction might follow. Obviously the latter could be a matter of great importance.

It is interesting to note that the Campbell Committee recommended that deposit taking institutions in this latter group which draw their funds mainly from the household sector should be brought under a nationally operating framework or alternatively should operate under prospectus requirements like

the finance companies. This would bring virtually all deposit taking institutions which draw on household savings under some form of prudential supervision.

Let me now give a brief answer to the question liberty or license for financial intermediaries?

My answer is "yes and no".

As Will Rogers put it "liberty don't work as good in practice as it does in speech".

I believe the financial system should include a wide spectrum of intermediaries providing an array of risks and returns.

Further, to the extent practicable, the individual should be free to make his own judgements.

However, as the world is at present, the community needs at least some safe havens. These safe havens are likely to be the stronger and inspire more community confidence if they have well-established liquidity and solvency support arrangements. Those arrangements should be as light and flexible as is consistent with the job to be done. The cost should be regarded as an insurance premium against the possibility of widespread financial disaster.

Now for a change of tack! One may wonder whether the need for intervention always existed. Has increasingly fierce competition put too much pressure on standards? Are profit and growth targets putting past canons of prudence under strain? Has inflation produced almost unmanageable uncertainty about financial trends? Has the remoteness of modern big business adversely affected attitudes?

Let me share with you the response to my queries:

The passage from Adam Smith which I have already mentioned shows how little general support the advocates of licence can claim from him. He was well aware of the importance of restraint in areas where private actions may have unaccountable social consequences.

He would not have sanctioned the total abandonment of laws designed to protect society from the self-interested actions of individuals.

There is another deeper reason why the advocates of licence cannot claim the support of Smith. The popular view of the writings of Smith is distorted by the immense stature of "The Wealth Of Nations". This single work has been so influential as to overshadow everything else he wrote. And yet, "Wealth Of Nations" was meant to be read within the context set by the earlier and much less famous work, "The Theory Of Moral Sentiments".

The social analysis developed in "The Theory Of Moral Sentiments" constitutes the ethical base on which the economical analysis of "The Wealth Of Nations" is developed. Smith's advocacy of the free market as a means by which individual self-interest may be harnessed to promote the general good is predicated on his views of man as a moral being.

The dependence of classical *laissez-faire* economics on the existence of a moral code is often overlooked in present-day discussions of the role of Government in the market place.

In his book, "The Social Limits to Growth", Fred Hirsch identified what he called "the depleting moral legacy" and analysed its importance for the future of capitalist society. He pointed out the central role which such traditional virtues as truthfulness, trust, acceptance, restraint and obligation play in the functioning of an individualistic market-based economy.

He concluded that the decline of traditional values (a process which he attributed to the market system itself) will gradually impair the hitherto unmatched performance of unregulated markets in the generation of material wealth.

Hirsch's analysis focuses attention sharply on the importance of filling the vacuum. To the extent that social mores cannot be relied upon to keep people honest and prudent, it can be argued that there is a role for Government to impose standards of acceptable behaviour and to ensure that those standards are met. Thus we might expect the efficient functioning of markets to require a larger body of law in the 1980's than was envisaged by Smith in the 1770's.

However, at the time Smith wrote of the "invisible hand" the parties to transactions were generally in closer contact with each other than is the case today. No doubt this intimacy re-enforced custom and morality. Further, one might ask whether the moral tone in the U.K. is less today than it was in that U.K. which filled the "First Fleet". Perhaps the problem is not moral atrophy but scale. No longer can we watch one another! Scale is of course, largely a result of markets.

Walter Bagehot pointed out in his "Lombard Street" the virtues of the great families of merchant princes such as those of Venice and Genoa. Great families he said, with reputations at stake, dare not be guilty of small frauds. He remarked somewhat sadly that they were pushed out by what he described as "the dirty crowd of little men".

But he considered this defect of the democratic system compensated by one great excellence — namely the promptitude with which the new men seized business advantages. Maintenance of the status quo, he said, denied the "propensity to variation" which, in the social as in the animal kingdom, is the principle of progress.

Nor should I leave the impression that wisdom always prevailed in Smith's time. One example might establish this point. That is the famous case of the "South Sea bubble".

The South Sea Company was formed in 1711 and was granted a monopoly of British trade with South America and the Pacific islands. In the early days of its career the price of its shares remained reasonably stable. Its trading business

with the South Sea islands did not progress, but it was moderately successful in its financial undertakings in the U.K.

Those connected with it, however, appeared impatient at the slow progress it was making. They decided to enhance the scope of the operations and accordingly contracted to take over responsibility for the national debt in exchange for trading privileges, particularly in Spanish possessions. Incidentally, they outbid the Bank of England in taking over the national debt.

This move initiated considerable fluctuation in the price of South Sea stock and eventually gave rise to a speculative boom. The boom engulfed the South Sea company as well as many other "bubble" companies formed expressly to take advantage of the speculation fever.

A striking example of the gullibility of the operators of those days is provided by the fact that a thousand persons in one morning paid two guineas each as a first instalment for shares in a company formed "for carrying on an undertaking of great importance, but nobody to know what it is". The promoter of this enterprise, by the way, disappeared the same afternoon with the two thousand guineas he had collected.

Eventually the "bubble" burst and the downfall of "bubble" companies brought South Sea stock and thousands of speculators down with them. The Bank of England which had held stock in the South Sea Company got out in time and no doubt learnt something from experience.

The response of the British parliament to the episode of the bubble was to pass various acts designed to discourage speculation. Indeed this has been the response of governments to subsequent episodes of speculation and misadventure which have occurred down the years to the present day. Much of our international monetary system and some central banks are derived from trouble caused by the speculative excesses of the late 1920's.

So we might conclude that man has not changed much but the economic system has become larger, more complex and consequently impersonal.

Probably there has been a decline in the role of personal morality as a force in business relations.

At the same time we should remember that too much official intervention and regulation can sacrifice dynamism and deny the community both liberty and growth. How to strike the balance is a question that must concern all politicians and bureaucrats.

Finally, something from Galbraith. He said that he seeks to leave his audiences older but wiser. If not too much wiser then not too much older!

In that context I have already gone on too long.